

NAVAL WAR COLLEGE
Newport, R.I.

A National Economic Strategy

By

Andrew K. Weaver
Lt Col, USAF

19981208 009

A paper submitted to the Faculty of the Naval War College in partial satisfaction of the requirements of the Electives Program.

The contents of this paper reflect my own personal views and are not necessarily endorsed by the Department of the Defense.

Signature

Andrew K. Weaver

15 May 1998

REPORT DOCUMENTATION PAGE

1. Report Security Classification: UNCLASSIFIED			
2. Security Classification Authority:			
3. Declassification/Downgrading Schedule:			
4. Distribution/Availability of Report: DISTRIBUTION STATEMENT A: APPROVED FOR PUBLIC RELEASE; DISTRIBUTION IS UNLIMITED.			
5. Name of Performing Organization: Dean of Academics Office			
6. Office Symbol: 1		7. Address: NAVAL WAR COLLEGE 686 CUSHING ROAD NEWPORT, RI 02841-1207	
8. Title (Include Security Classification): A National Economic Strategy (U)			
9. Personal Authors: Lt Col Andrew K. Weaver, USAF			
10. Type of Report: FINAL		11. Date of Report: 15 May 1998	
12. Page Count: 16			
13. Supplementary Notation: A paper submitted to the Dean of Academics, Naval War College, for the B. Franklin Reinauer II Defense Economics Prize essay competition. The contents of this paper reflect my own personal views and are not necessarily endorsed by the NWC or the Department of the Navy.			
14. Ten key words that relate to your paper: economics, grand strategy, economy, economic strategy, security, education, foreign aid, national security strategy, federal budget			
15. Abstract: This paper outlines a national economic strategy to support the national security strategy. The proposed strategy is 2-pronged. First, a domestic component that proposes a reduction of the federal government's role in the economy and proposes a plan to grow the economy. Privatizing social security and reforming education with a voucher plan reduces the federal government's role. To improve the economy requires increasing productivity. Increasing capital and improving education improves productivity. The privatization of Social Security and educational reform proposals will improve productivity. The second prong, the international component, employs the economic instruments to achieve U.S. goals overseas. Specifically, the U.S. will focus on assisting nations in their efforts to improve their governance vice dispensing foreign aid. Our efforts will concentrate on four pivotal states—Mexico, Russia, China, and Turkey. At the same time, the United States will continue to improve international markets by promoting the lowering of tariffs and promoting international standards of banking, securities, and accounting.			
16. Distribution / Availability of Abstract:	Unclassified X	Same As Rpt	DTIC Users
17. Abstract Security Classification: UNCLASSIFIED			
18. Name of Responsible Individual: Dean of Academics, Naval War College			
19. Telephone: 841-2245		20. Office Symbol: 1	

A National Economic Strategy

The foundation of a nation's power is its economic strength relative to other nations. For example, at the end of World War I, the United States experienced a near overnight rise in its international stature. The newly found stature was not a function of its military strength—the United States had the smallest military of all the major participants.¹ Instead, it was recognition of the United States' newly achieved economic pre-eminence. Likewise, the rapid decline of the British Empire after World War II, despite being one of the allied victors, was due in large part to her economic exhaustion.² Economic strength is the foundation of national power. This paper will propose a 2-pronged economic strategy to support the U.S. National Security Strategy. The domestic component seeks to improve the U.S. economy while the international component employs economic instruments to help achieve U.S. goals overseas.

National interests are the beacons to guide a grand strategy. U.S. national interests are four: (1) survival of the homeland and its constitutional form of government, (2) the economic well being of the US, (3) to promote our values overseas, and (4) survival of our allies. The aims of a grand strategy are derived by viewing U.S. national interests

¹ France, Russia, Italy, Germany, Austria-Hungary, and the British Empire all mobilized larger forces. R. Ernest Dupuy & Trevor N. Dupuy, *The Encyclopedia of Military History from 3500 B.C. to the present*, 2d ed., (New York: Harper & Row, 1986), 990.

² This is not to denigrate the role of nationalist movements within the colonies.

through the lens of the current strategic environment. With the end of the Cold War, the United States is experiencing a strategic lull. There is no peer competitor for the near future. The lull will permit a smaller defense budget, which in turn leads to a federal budget consuming a smaller percentage of the GDP. This assumes that other federal spending does not balloon. However, a strategic lull does not mean the world is threat-free. Both Russia and China are attempting to integrate into the liberal market-based world order. So are many other countries as well. Countries across the globe are transitioning from state-controlled and mixed economies to market economies.

Given the present strategic environment, the aims of U.S. grand strategy are: (1) deter aggression against ourselves or our allies, and should deterrence fail to defeat the adversary, (2) a vibrant economy with unfettered access for our goods abroad, and (3) an increasing community of like-minded nations. The objective of the domestic component of this strategy is to ensure the U.S. economy remains vibrant. A vibrant economy should provide the citizenry a rising standard of living as well as the economic base to support a larger military should the strategic environment change. The international component's objective is to increase the community of like-minded nations, provide for regional stability so the strategic environment does not significantly shift, and continue to lower trade barriers for all goods.

Domestic Component

The domestic component must address the appropriate role of the government in the economy as well as outline a strategy to grow the economy. For the last decade, the percentage of the Gross Domestic Product (GDP) consumed by the federal government

has held steady. At the same time, the federal budget has gone from chronic deficits to a projected surplus. Nonetheless, the federal budget threatens to spin out of control again with the baby boomer pincer attack of 2012—Social Security and Medicare. If the federal budget is to remain in balance, and not consume a larger part of the GDP, the federal government must control Social Security and Medicare spending.

Such a reduction can be part of a larger examination of the federal government's role in the economy. The present definition of government's role in society is largely a result of President Franklin Roosevelt's New Deal programs of the 1930s. The United States had just transitioned from an agrarian society to an industrial society and was in the depths of the Great Depression. President Roosevelt promised the voters a balanced budget, but a balanced budget of a different kind. He sought a budget that brought balance between workers and their companies.³ Sixty-odd years later, the United States is in the midst of a transition from an industrial society to an information society, it is time to reevaluate the utility of some key government programs. This strategy will propose two major changes that decrease the federal government's role in the economy—Social Security and education.

Reforming Social Security

In 2012, baby boomers will begin to retire causing Social Security payments to exceed revenues. Theoretically, Social Security can draw from its surpluses held in its trust fund. However, the federal government has already consumed these surpluses and

³ James D. Savage, *Balanced Budget & American Politics*, (Ithaca: Cornell University Press, 1988), 165.

given the Social Security Administration government bonds in return. When Social Security begins to redeem those bonds the federal government will have to further increase the deficit, increase taxes, or cut other government spending.

An alternative approach is to privatize Social Security. When President Roosevelt instituted social security in the 1930s, the average worker did not have a retirement program. The elderly were dependent upon their families, forced to work, or destitute. Social Security was a fix to a market failure. However, times have changed. Nowadays, the average employer provides employees a retirement plan. In addition, improved wages (thanks to improved productivity) and changes in the tax code (individual retirement accounts and 401k plans) have prompted many to save for their own retirement. The market is now capable of solving this problem and government intervention is no longer required.

Under the privatization proposal, the role of the federal government would be to establish the framework for retirement savings. No longer would the federal government collect Social Security taxes. Instead, individuals would direct the same funds into a private retirement account. The federal government would have three major responsibilities under privatization. First, it would establish policies on how much money workers could contribute. Second, it would establish the standards for private retirement accounts much as the federal government establishes standards for mutual fund companies. Third, should any individual find himself at retirement age with a private retirement account insufficient to fund a retirement equal to the poverty line, the federal government, through welfare, would make up the difference.

To determine if such a proposal can be successful, one need only look at Chile. Chile, the first Western Hemisphere nation to adopt a social security program (1925), was also the first to privatize their social security system. Faced with a financial crisis in their social security system 16 years ago, much like the one the United States faces today, Chile privatized their system. After 16 years, Chilean pension benefits are 50 to 100 percent greater than those provided by the previous state system ⁴

The benefits from privatizing social security include improving the U.S. economic growth rate and balancing the federal budget, which in turn will decrease the U.S. trade deficit. It will also redirect money the federal government siphons off for current consumption to long-term capital. The increase of capital is an essential ingredient in improving worker productivity. The Chilean experience suggests that retirement benefits are greater under the privatized system, which in turn improves the standard of living for retirees.

Reforming Education

The domestic component of our economic strategy seeks to grow the U.S. economy. Growth will be measured by improved standards of living. An important part of improving productivity is to improve the education of the workers. Many state and local governments have increased their expenditures on education without achieving any substantive increase in student scores. The underlying problem in our education system is the lack of competition to spur change. Presently, government has a near monopoly on

⁴ Jose Pinera, "A LOOK AT . . . The Future of Social Security: In Chile, They Went Private 16 Years Ago," *The Washington Post*, 22 Mar 1998, C03. <<http://www.washingtonpost.com>> (22 Mar 1998)

K-12 education. The only choice in schools is a function of one's address. Only consumers with sufficient financial resources to enroll in a private school can opt out of the government monopoly.

A voucher system will introduce competition by providing all members of society the same opportunity as the affluent. The government will provide the parents of each student a voucher they can redeem at any accredited school. In addition to providing the voucher, government's role would be to establish accreditation standards for the schools and attendance regulations for the students. Schools would either provide a suitable product or risk consumers taking their vouchers to schools more responsive to their needs. The competition for customers would force the schools to innovate. Those governments closest to the problem—local—are best suited to handle education. Consequently, the federal government's role in education would be small.

However, the federal government's role in educational reform can be large. The federal government will provide a large leadership role by implementing a voucher system within the District of Columbia. The U.S. Congress is the local government for the District. The District's schools are in shambles, physically as well as the product they produce. A successful voucher program in the District will provide the impetus for state and local governments across the nation to adopt school vouchers. As Peter Drucker asserted in *Post-Capitalism Society*, the present education system is a mass-production scheme to produce standardized students to work in an industrial plant. Today's information age economy needs workers who can exploit knowledge. To achieve our economic goals, the United States requires a new educational paradigm, and competition,

stimulated by vouchers, should provide the necessary spur. In addition to forcing today's industrial age schools to innovate, school vouchers will ensure a quality education is available to a larger set of the citizenry. In turn, the fruits of our economic success should be distributed across a wider range of our nation.

Improving Economic Growth

The proposed Social Security and education reforms have a dual purpose. First, as previously outlined, the reforms will decrease the role of government within the economy. Second, the reforms will further economic growth. The most important factor affecting economic growth is productivity growth. To improve productivity requires giving the workers increased capital and a better education.⁵ Improved productivity will lead to a better standard of living. An improved standard of living—not self-sufficiency—is the measure of merit for a successful economic strategy.⁶ The standard of living improvement must be as widely distributed as possible. The disenfranchisement of people from the country's economic success will undermine the government's legitimacy.

To improve investment requires both the citizenry and the government consume less. The recent change to the tax code establishing the Roth Individual Retirement Account is a good step to decrease household consumption. The proposed privatization of Social Security is the complementary step to decrease government consumption. It will redirect the money the federal government siphons off for current consumption towards

⁵ Paul Krugman, *The Age of Diminished Expectations*, 2d ed., (Cambridge, MA: The MIT Press, 1995), 20.

⁶ Modern nations with an autarkic policy, e.g., Soviet Union, Nazi Germany, Imperial Japan, Albania, have failed. The only exception is North Korea and it is on its death bed.

long-term capital. Again, Chile provides an example of what is possible. Since privatizing their Social Security, the growth rate of the Chilean economy has increased from its historical three percent growth rate to seven percent for the last 12 years.⁷

The other half to improving productivity is to improve education. Spending additional funds on education is not the solution. Many districts have increased the educational expenditures and not received a corresponding improvement. The American educational system requires a structural change. America was able to make the transition from an agricultural economy to an industrial economy in part due to the advent of the modern high school.⁸ The competition prompted by the voucher program will spur the structural change necessary to improve the quality of the education in the United States. Reinvigorating U.S. schools will also expand the well of American creativity.

To grow the economy the United States will depend upon improved productivity and the creativity of our citizenry. The United States will eschew an industrial policy. Government ministries have repeatedly proven themselves incapable of picking the industries and products a national economy should focus on. Furthermore, an industrial policy runs counter to our philosophical underpinnings—minimal government interference in the economy. Instead, the creativity of U.S. citizens is the best weapon. Without any intentional government policies, the United States already is the world leader in the dominant industries of the next century, e.g., aerospace, telecommunications, computer hardware and software, pharmaceuticals, and biotechnology. To continue this trend the U.S.

⁷ Pinera, C03.

⁸ David Walsh, "Economic Principals: The Coming Boom?," *The Sunday Boston Globe*, 3 May 1998, J3.

Government will continue to search and dismantle government impediments to creativity and innovation.

International Component

The international component will address how economic means will be used to shape the international environment. Specifically, the strategy will seek to maintain a favorable strategic environment with an expanding bevy of market-based economies. This will not be an easy task since the strategic environment is very dynamic. Today a significant part of the world is undergoing a transformation from state-controlled and mixed economies to market-based economies. Many of the countries will successfully make the transition; some will not. Moreover, the results are not immutable—this is not the end of history. Consequently, the United States will devote a sizable effort to support this transformation to increase the community of market-based economies. This goal is important to the United States for two reasons. First, an expanding liberal trading order is the type of world the United States wants to live in. It has been a U.S. goal since President Roosevelt and Prime Minister Churchill signed the Atlantic Charter in 1941. Second, improving regional stability can reduce the need for U.S. military forces overseas. A decreased demand, in turn, will help relieve OPSTEMPO problems the military is presently experiencing. The breakdown of governments and the resulting deployment of U.S. troops can degrade our military's readiness. "The evolution of a more secure and predictable environment will allow the United States to promote its interests globally without

employing military forces as often as we do today, and should be central to our security strategy.”⁹

Improving Governance

To assist nations during their transition the United States will embrace a good governance program and eschew foreign aid. Good governance will supplant our previous use of foreign aid to spur foreign development. Foreign aid was a large staple of our foreign policy during the Cold War and helped build our basket of allies in Third World countries. However, foreign aid also reinforced bad governments. Often the aid financed development projects that supported the country's leadership and had a corrupting influence. In turn, it perpetuated ineffectual leaders whose poor administration led countries to ruin. Bad governance is the heart of the problem in Africa and to a lesser degree in Latin America and Southeast Asia.

Instead of unintentionally perpetuating bad governance, U.S. efforts will shift to helping countries, who ask for our help, govern better. The good governance program will be an interdepartmental effort integrated by the U.S. country team in the host nation. Although each country's situation is unique, typically the interdepartmental teams will include the Justice, Commerce, and Defense Departments, as well as the Securities and Exchange Commission. A typical team could advise a country on legal, business, and securities codes, the judiciary and law enforcement organizations necessary to enforce the codes, and civil-military relations. The teams will serve as advisors and not dictate solu-

⁹ National Defense Panel, *Transforming Defense—National Security in the 21st Century*, December 1997, 29. <<http://www.dtic.mil/ndp>> (25 Mar 1998)

tions. Nations must develop and take ownership of their own solutions. Otherwise, countries will perceive the United States is bullying them. If so, the United States could fall into the same power-security dilemma as Athens before the Peloponnesian War.

Those countries that successfully institute competent governments will attract international investment capital into their countries. Conditions have changed since World War II when there was little investment capital available internationally. Now the markets can perform this function and the U.S. government can stand aside. So should the World Bank. Just like U.S. foreign aid, World Bank loans do not promote good governance. The knowledge that an international organization stands ready to bail out your country if it fails prompts bad behavior and prevents the necessary reforms.¹⁰

Pivotal States

Given the United States lacks unlimited resources, the good governance program's primary, although not exclusive, focus will be on Mexico, Russia, China, and Turkey. These are the pivotal states to our national security strategy. If they fail in their transition, it will affect the surrounding regions.¹¹ Although the Western European nations are important to our national security, they do not require a large amount of our assistance. The Western European nations are transitioning from mixed economies not state-controlled economies. These nations already have the requisite legal, business, and securities codes. Instead, the governments must transition from owner and controller to

¹⁰ Jim Rogers, "The Ponzi Pair," *Worth*, May 1998, 45.

¹¹ Robert S. Chase, Emily B. Hill, and Paul Kennedy, "Pivotal States and U.S. Strategy," in Strategy and Force Planning faculty (eds.) *Strategy and Force Planning* (2d ed.) (Newport: Naval War College Press, 1997).

referee and regulator.¹² We expect the Western European nations will assist the Eastern European nations in their transition as part of the expansion of the European Union.

The first of the four pivotal countries is Mexico. Mexico's inability to provide an equitable economy for the majority of her citizens is the underlying reason why our southwestern states are plagued with vast illegal immigration. We have no such problem from our northern neighbor, Canada, with its vibrant economy. Mexico has undertaken the first step to improve its governance—the migration to a multi-party government. This has the potential to reduce significantly the corruption within Mexico but alone it will be insufficient. The other corrupting influence in Mexico is the drug rings that use Mexico as a staging area to supply narcotics to the United States. To date our interdiction of drugs has not significantly changed drug usage in America. To support Mexican reforms, as well as reforms throughout Latin America, the United States must curb its appetite for illegal drugs. A demand reduction strategy will yield better results than our present supply reduction strategy.

Russia is the second pivotal nation. In the midst of transitioning from a state-controlled economy, Russia has achieved limited success to date. For example, Russia is much further along than China in shedding itself of its state owned enterprises; however, the distribution of wealth is concentrating itself within a small class of individuals. If Russia cannot provide for the majority of its citizens, vice a growing criminal class, it risks regressing to a totalitarian government. Should a totalitarian government emerge

¹² Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: The Battle Between Government and the Marketplace That is Remaking the Modern World*, (New York: Simon & Schuster, 1998), 377.

while at the same time NATO continues to expand, Russia may no longer perceive the international environment to be legitimate. If so, Russia may be unwilling to resolve its problems within the normal international framework. This could dramatically upset the strategic environment.

China, like Russia, is transitioning away from a command economy; however, China is different. In some respects, China leads Russia, e.g., the vast entrepreneurial areas along the coast. In other respects, it lags Russia, e.g., China has yet to sell many of its state-owned enterprises and its government remains totalitarian. China already has the second largest economy. By 2020, it could rival the U.S. economy.¹³ Couple such economic power with a growing military capability and it could upset the strategic equation in the Pacific.

The final pivotal state is Turkey. Turkey is the key to the Central Asian Republics of the former Soviet Union. Because of their cultural ties, the Republics look to Turkey as a role model. The United States has an interest in Turkey improving her governance and strengthening her ties with the Republics. First, it could inoculate the new Republics from radical Islam that threatens many Islamic countries. Second, the Central Asian Republics are rich in oil and could provide the United States an alternative source of oil to the conflict-ridden Persian Gulf.

¹³ Yergin, 376.

Improving International Markets

The ability of capital to move at the speed of light prompts the need for international standards of banking, securities, and accounting. Previously, when markets were local, the market frameworks established by nations were sufficient. Nowadays financial markets transcend national boundaries and their national regulations. The free movement of capital suggests there is a need for an international framework. The United States will work with the other nations to develop such an international framework. International standards in banking, securities, and accounting should provide the transparency to further international investment. This initiative will complement our efforts to promote good governance. Good governance will attract foreign investments and in turn reduce the need for foreign aid and the World Bank.

In addition to promoting the movement of capital across borders, the United States will promote the free flow of goods across borders. Since World War II, many tariffs have decreased. The United States will continue to advocate removing trade barriers. Our first priority will be those industries in which the United States holds a definitive lead. For example, the United States holds a dominant position in pharmaceuticals, computers (hardware and software), telecommunications, aerospace, and airlines. All of these areas will be key industries in the next century. Our efforts will be both on a global basis, e.g., continue to enhance the World Trade Organization, and on a regional basis, e.g., expand the North American Free Trade Area into an All-American Free Trade Area. At the same time, the United States must prevent regional trading areas from developing into regional trading blocks. To achieve that goal, the United States will position itself as

the member who transcends the regional trading organizations. The goal is to enhance our access to foreign markets and take advantage of our preeminence in the key industries of the next century.

Finally, economic sanctions have become increasingly popular means for the U.S. government to conduct foreign policy. Our new economic strategy will de-emphasize the use of economic sanctions because they are usually ineffective, costly to our economy, and divisive among our allies. An Institute of International Economics report found economic sanctions to be effective only 20 percent of the time. Such a paltry success ratio cost the US economy \$15-19B in 1995.¹⁴ The long-term costs may be greater as international trading partners find the United States to be an unreliable trading partner and go elsewhere. Instead of being the weapon of first choice, economic sanctions will be employed only on the most vital of issues and then only in concert with the other instruments of power.

Summary

Economic strength is the bedrock of national power. The proposed economic strategy has shown how the United States can employ economic means to attain the aims of U.S. grand strategy. Reforming Social Security and education will improve American productivity, which in turn promotes the economic growth necessary for a vibrant economy. At the same time, the U.S. program to assist governments improve their governance reduces the number of states that will fail and require U.S. military intervention.

¹⁴ Claude E. Barfield and Mark A. Groombridge, "Shooting Yourself in the Foot," *Barron's*, 13 October 1997, 70.

Improving governance and international markets will enhance regional stability. Regional stability leads to a more stable strategic environment and together enables the United States to have a smaller military without increasing risk. However, should deterrence fail, the vibrant economy, fueled by improved productivity, should provide the military with the best possible weapons and in sufficient quantities to achieve our policies. Well-crafted economic policies can be intertwined with the other instruments of power to enable the U.S. grand strategy to achieve our national aims. The 20th Century has been labeled the American Century, in large part because of its economic strength. Whether the 21st Century is also an American Century is dependent upon our ability to continue our economic success.

Bibliography

- Barfield, Claude E. and Mark A. Groombridge, "Shooting Yourself in the Foot," *Barron's*, 13 October 1997, 70.
- Chase, Robert S., Emily B. Hill, and Paul Kennedy, "Pivotal States and U.S. Strategy," in Strategy and Force Planning faculty (eds.) *Strategy and Force Planning*, 2d ed. Newport: Naval War College Press, 1997.
- Dupuy, Ernest & Trevor N. Dupuy, *The Encyclopedia of Military History from 3500 B.C. to the present*, 2d ed. New York: Harper & Row, 1986.
- Krugman, Paul, *The Age of Diminished Expectations*, 2d ed. Cambridge, MA: The MIT Press, 1995.
- National Defense Panel, *Transforming Defense—National Security in the 21st Century*, December 1997, <<http://www.dtic.mil/ndp>> (25 Mar 1998)
- Pinera, Jose, "A LOOK AT . . . The Future of Social Security: In Chile, They Went Private 16 Years Ago," *The Washington Post*, 22 Mar 1998, C03.
<<http://www.washingtonpost.com>> (22 Mar 1998)
- Savage, James D., *Balanced Budget & American Politics*. Ithaca: Cornell University Press, 1988.
- Rogers, Jim, "The Ponzi Pair," *Worth*, May 1998, 43-46.
- Walsh, David, "Economic Principals: The Coming Boom?," *The Sunday Boston Globe*, 3 May 1998, J1 & J3.
- Yergin, Daniel and Joseph Stanislaw, *The Commanding Heights: The Battle Between Government and the Marketplace That is Remaking the Modern World*. New York: Simon & Schuster, 1998.